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BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
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COMMISSIONER

Arizona Corporation Commission
DOCKETED

JUL 18 2001

DOCKETED BY

IN THE MATTER OF THE APPLICATION OF THE ARIZONA ELECTRIC POWER COOPERATIVE, INC. FOR VARIOUS AUTHORIZATIONS ASSOCIATED WITH ITS RESTRUCTURING	DOCKET NO. E-01773A-00-0826 **AEPCO'S EXCEPTIONS TO THE STAFF PROPOSED OPINION**

The Arizona Electric Power Cooperative, Inc. ("AEPCO") submits these exceptions to the Staff Proposed Opinion filed on July 13, 2001. The Commission's Order approving the restructuring will bring to a close a more than five year retail member/member distribution cooperative/AEPCO study and implementation process. All other approvals necessary or related to the closing have been secured including those of the Rural Utilities Service, the Federal Financing Bank, the Federal Energy Regulatory Commission, the Internal Revenue Service, the Securities and Exchange Commission and the Class A member distribution cooperatives.

AEPCO and its members are confident the restructuring will accomplish its goals including the five primary benefits discussed at pages 5-6 of the Application. Late last month in Washington, the parties executed and tendered into escrow the final documents necessary to complete the transaction. Closing is scheduled for July 31, 2001.

AEPCO has worked diligently with Staff over the past several months in processing its Application. It has closely reviewed the Staff Report and Proposed Opinion. While AEPCO does not necessarily agree with all portions of the analysis or recommendations,

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it does compliment Staff for a thorough review of what is, simultaneously, a simple in concept yet complicated in detail transaction.

In order to focus issues and narrow items in dispute, AEPCO directs these exceptions to only three areas.

Ministerial Corrections

Attached as Exhibit A is an errata amendment. It is not intended substantively to change the Proposed Opinion. Instead, it corrects typographical errors, clarifies certain technical details and conforms the Proposed Opinion to recommendations and requests contained in the Staff Report and Application.

Rate of Return/Fair Value

Attached as Exhibit B is a short amendment pertaining to rate of return and rate base findings. In light of several recent appellate rulings concerning this subject, AEPCO would request that the Commission add this information to Finding of Fact No. 3. It is taken from the financial information submitted as Exhibit C to the Amended Application and supports the just and reasonable rate conclusions on page 13 of the Proposed Opinion.

Rate Case/Code of Conduct Issues

Attached as Exhibit C is an AEPCO response amendment on two substantive issues which AEPCO asks that the Commission address. The first issue concerns the Staff recommendation that AEPCO and Southwest file a rate case within 18 months of the date of closing. That recommendation should be modified, at a minimum, and preferably abandoned altogether.

At Finding of Fact No. 63, Staff states three reasons to support its future rate case suggestion: (1) assure fair asset/liability allocations among the three entities; (2) ensure restructuring savings exceed costs and benefit the members' retail customers and (3) assure that rates are fair and reasonable. None of these rationales supports the considerable--and very likely unnecessary--time and expense of a rate case.

As to the first issue, AEPCO, Southwest and Sierra are separate, non-profit member owned cooperatives owned by the same members presently involved in AEPCO. Assets and liabilities are being carefully assigned and allocated among each entity in the manner described in the Application and pursuant to independent appraisal and detailed legal agreements. AEPCO will purchase transmission services from Southwest pursuant to the FERC approved OATT. AEPCO will continue to sell power to its Class A members pursuant to a Commission approved tariff. Sierra will supply staffing services to AEPCO and Southwest pursuant to negotiated agreements. All of this is overseen by consumer controlled Boards of Directors and committee structures.

As to the second issue, AEPCO would stress that an objective of the restructuring has never been to drive cost savings. This is not a merger or acquisition transaction designed to increase efficiencies by enlarging the consumer base or reducing the work force. The day after close the same assets supported by the same debt administered by the same employees serving the same consumers will exist as the day before close. While AEPCO and its members are confident that advantages such as increased competitiveness, focused financing, operational efficiencies and more flexible purchase power arrangements will benefit the members and their member retail customers, these benefits are primarily qualitative and difficult to quantify--particularly in only the next 18 months. No savings benefit analysis should be required in these circumstances. As to making sure benefits reach the "ultimate consumer," that's the only place they legally can go in a cooperative structure overseen by consumer controlled Boards.

As to assuring fair and reasonable rates, attached as Exhibit D is the Cooperative's rate reduction history. It details the more than 22% decrease in AEPCO's rates over the past 15 years. In addition, during the same time period, including the $6.7 million in PPFAC forgiveness authorized here, AEPCO has returned in cash or forgiven another $23 million to its members. Also, as Staff notes at Finding No. 54, the current proposed rates would have produced another $1.0 million decrease in power bills last year.

A rate case filing is simply not needed. Alternatively, if the Commission wants such information, AEPCO suggests (1) extend the filing to 24 months from the closing to allow a full fiscal calendar year to occur which will afford audited data on which to premise the filing and (2) only require an informational filing with Staff. This would still allow an inquiry but without an automatic commitment to the time and expense of an arguably completely unnecessary rate case.

As to the Code of Conduct issues covered at Findings of Fact Nos. 31-39 and 64, AEPCO agrees with Staff that the Commission should approve the Codes of Conduct and retain jurisdiction to oversee them. It does not, however, agree that any review should occur in a rate case. Rather, if necessary, such a review should logically take place in a proceeding noticed to the appropriate parties for that purpose.

Briefly addressing some of Staff's stated concerns, the entire Code of Conduct concept does not apply very well to the cooperative structure.[1] The cooperatives are already and always have been disaggregated--legally, physically and functionally. AEPCO or Sierra do not have retail information. The member distribution cooperatives do not have wholesale information. To further cement the separation, the Sierra/member distribution Code attached as

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[1] In recognition of that fact, the Commission's Affiliate Interest Rules do not apply to cooperatives. R14-2-801, et seq.

Exhibit D to the Application provides at its Section D that Sierra may receive confidential customer information only after written customer approval and only on the same basis as any other ESP.

Staff expresses a concern about Sierra functioning in both the wholesale and retail markets. All ESPs function in both the wholesale and retail markets. If nothing else, they must buy at wholesale in order to have a product to deliver at retail.

The Legislature has specifically authorized cooperatives to engage in joint marketing activities. A.R.S. §§ 10-2057.A.4 and 10-2127.A.5. Absent such authorization, Arizona's rural areas will be as unserved or underserved by the competitive market as they were by the regulated market prior to cooperatives' electrification efforts.

AEPCO requests that the Commission approve the Codes of Conduct as recommended by Staff in Finding No. 37. Should, however, a future review be necessary, it should not as suggested in Finding Nos. 39 and 64 be conducted in a rate case but rather a proceeding noticed to address whatever issues are identified and by whom.[2]

CONCLUSION

AEPCO requests that the Commission enter its Order approving the restructuring with the amendments set forth in Exhibits A, B and C. A revised form of Proposed Opinion incorporating these amendments is attached as Exhibit E.

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[2] Practically, AEPCO suspects that there would be nothing to address in a 2003 rate case in any event given the current and expected state, or lack thereof, of the competitive market.

RESPECTFULLY submitted this 18th day of July, 2001.

GALLAGHER & KENNEDY, P.A.

By Michael M. Grant

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Copies of the foregoing delivered this [illegible] day of July, 2001 to:

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By: [illegible]
10421-0008/941569

A

PROPOSED ERRATA AMENDMENT
(References to Proposed Opinion)

p. 2, l. 11 - Insert “A” after “Class”.

p. 2, l. 19 - Strike “new,”.

p. 2, l. 23 - Strike “broker” and insert “trader”.

p. 3, ll. 14-18 - Strike the first three sentences of the Finding and insert the following:

> “Southwest will finance the purchase of the transmission assets by assuming $96.2 million of existing AEPCO debt. Southwest will assume $66.1 million of RUS debt and guaranteed debt and will enter into assumption and indemnity agreements as to the balance of the assumed debt with other AEPCO lenders.”

p. 3, l. 24 - Strike “Class” before “Members”.

p. 3, l. 27 - Insert “its Class A all requirements members,” after “sales to”.

p. 5, l. 4 - Strike “approves” and insert “approve”.

p. 5, l. 16 - Insert a period at the end of the sentence.

p. 5, l. 22 - Strike “they are” and insert “it is” before “retaining”.

p. 6, l. 5 - Strike “National Cooperative Financing (“CFC”) mortgages” and insert “National Rural Utilities Cooperative Finance Corporation (“CFC”) mortgage”.

p. 6, l. 6 - Strike “mortgages” and insert “mortgage.”.

p. 6, l. 12 - Insert new sentence as follows:

> “These capital contributions and credit support fulfill Sierra’s financial information compliance condition of Decision No. 61932.”

p. 6, l. 14 - After “debt.” insert new sentence:

> “It also has debt outstanding to other lenders including the CFC.”

p. 6, ll. 19-21 - Strike the second sentence of the finding and insert the following re-worded sentence:

> “The purpose of this restriction is to ensure that AEPCO and Southwest’s ability to make timely debt payments to RUS is not compromised by Sierra’s activities.”

p. 6, l. 23 - After “approval” insert “of the restructuring of AEPCO”.

EXHIBIT A

p. 7, ll. 1-2 - Strike "of they have RUS and RUS guaranteed debt" and insert "Sierra will not have operational control over either AEPCO or Southwest."

p. 8, l. 3 - Insert "and Southwest" after "it".

p. 8, l. 9 - Strike "its affiliates" and insert "Southwest and Sierra".

p. 8, l. 16 - After "issues" insert "according to Staff".

p. 9, l. 19 - Strike "that".

p. 9, l. 21 - Strike the quotation mark at the end of the sentence.

p. 10, l. 19 - Insert "the" before "proportion".

p. 10, l. 20 - After "requirement." insert the following new sentence:

> "The rate setting methodology is set forth in the transmission agreements between AEPCO and Southwest and Mohave and Southwest."

p. 10, l. 28 - Insert "million" after "$1.0".

p. 11, l. 9 - Strike "that".

p. 12, l. 7 - Strike "opened" and insert "open".

p. 12, l. 17 - After "Commission" insert "approve the Codes of Conduct attached as Exhibit D to the Application but".

p. 12, l. 25 - Strike "distribution" and insert "transmission".

p. 13, l. 11 - Strike "C" and insert "B".

p. 13, l. 22 - Strike "in" after "filed."

p. 14, l. 4 - Insert new ordering paragraph as follows:

> "IT IS FURTHER ORDERED that AEPCO, Southwest and Sierra are authorized to engage in any transactions and to execute any documents necessary to effectuate these authorizations and complete the restructuring."

10421-0008/941002

EXHIBIT A

B

RATE FINDINGS AMENDMENT

At page 2, l. 7 insert the following new sentence:

"AEPCO submitted rate base and other financial information as Exhibit C to the Amended Application demonstrating that the proposed rates would produce a rate of return of 7.35% on its total original cost/fair value rate base of $260,436,970 and 6.76% on its generation related rate base of $196,804,012."

10421-0008/941008

EXHIBIT B

AEPCO RESPONSE AMENDMENT

At page 13, l. 12, insert new findings as follows:

AEPCO Response

72. In response to the Staff analysis, AEPCO agreed to most of the Staff recommendations but offered several points of clarification and suggested certain amendments to two of the Staff recommendations.

73. As to Staff's rate case filing recommendation in Finding of Fact No. 63, AEPCO noted the following:

(a) Although AEPCO and its members do expect efficiencies and other advantages from the restructuring as summarized at pages 5-6 of its Application, these benefits are primarily qualitative or unrelated to immediate direct cost savings and would be difficult to quantify in the savings benefit analysis suggested by Staff. Therefore, if the Commission orders a rate case filing, AEPCO requests that such an analysis not be required as part of it.

(b) AEPCO also suggested that if a rate case filing is required, submitting it two years instead of 18 months from the date of closing would allow a full fiscal calendar year to occur and would also allow the rate information to be premised on audited numbers.

(c) AEPCO suggested that the Commission not order, as recommended by Staff, a rate case submission in 2003. Citing the expense and considerable cooperative and regulatory resources involved in such a filing, AEPCO maintained that there was no demonstrated need for such a requirement and it was premature and unnecessary.

(d) Alternatively, AEPCO suggested that the rate and cost of service study filing requirement instead be an informational submission to the Director of the Utilities Division two years after closing. This would provide Staff with information without prematurely committing this Commission and the cooperatives to a possibly unnecessary rate case.

74. Having reviewed the Staff recommendations and AEPCO's response, the Commission finds

(Alternate A) that no rate case filing should be ordered at this time.

OR

EXHIBIT C

C

> (Alternate B) that the rate case and cost of service study requirement should be an informational submission to the Director of the Utilities Division within 24 months of the date of closing containing no savings/benefit analysis. After review of the information submitted, Staff may forward to the Commission a recommendation on whether to proceed further.

75. In response to Staff's Code of Conduct recommendations in Finding of Fact No. 64 and its discussion of the subject in Findings of Fact Nos. 31-39, AEPCO noted that all electric service providers will operate in both retail and wholesale markets as will Sierra. As to Staff's stated concerns of Sierra working with member distribution cooperatives, AEPCO noted that the Code of Conduct contains various safeguards to assure that this does not confer a competitive advantage including the requirement that confidential customer information only be released after written customer authorization and be supplied to any other ESP on the same basis as it is provided to Sierra. Finally, AEPCO suggested that while the Commission retains jurisdiction to revisit issues associated with any approved Code of Conduct, that should not be done in the cooperatives rate cases, but rather in a proceeding noticed for that purpose for either AEPCO or the member distribution cooperatives.

76. Having reviewed the Staff recommendations and AEPCO's response, the Commission approves the Codes of Conduct attached as Exhibit D to the Application but reserves the right to address them further in proceedings noticed for that purpose involving AEPCO or the member distribution cooperatives.

At page 13, l. 25, after "61-71," insert "as modified in Findings of Fact Nos. 74 and 76,"

At page 14, l. 3, after "61-71" insert ", as modified in Findings of Fact Nos. 74 and 76".

10421-0008/941519

EXHIBIT C

D

AEPCO RATE REDUCTION HISTORY

On January 1, 1986 the following rates were in effect and used to calculate the Class A Member's bills.

Demand Rate	Surcharge	Energy Rate	Surcharge	PPFAC adj
$15.25/KW/mo	$.92/KW/mo	$.03179/KWH	$.00191/KWH	-$.00118

On March 1, 1986 the surcharge authorized in ACC Decision No. 54364 to be extended through February 1996 was allowed to expire for an approximate 5.8% rate reduction.

Demand Rate	Surcharge	Energy Rate	Surcharge	PPFAC adj
$15.25/KW/mo	Expired	$.03179/KWH	Expired	-$.00118

Effective April 1, 1990 the members' bills were calculated based on the APPA coincident peak rather than from members' non-coincident peak for an approximate 2.5% rate reduction. (See ACC Decision No. 56862)

Effective June 1, 1991, ACC Decision No. 57364, the PPFAC adjuster was changed for an approximate 8.5% rate reduction.

Demand Rate	Surcharge	Energy Rate	Surcharge	PPFAC adj
$15.25/KW/mo	Expired	$.03179/KWH	Expired	-$.00644

On September 3, 1993 AEPCO's general rate case was decided (Decision No. 58405) and AEPCO's Class A members experienced an approximate 5.5% reduction in rates.

Demand Rate	Energy Rate	PPFAC adj
$15.25/KW/mo	$.02228/KWH	$.00

10421-0008/941542

EXHIBIT D

E

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
Chairman
JIM IRVIN
Commissioner
MARC SPITZER
Commissioner

IN THE MATTER OF THE APPLICATION OF THE ARIZONA ELECTRIC POWER COOPERATIVE, INC., FOR VARIOUS AUTHORIZATIONS ASSOCIATED WITH ITS RESTRUCTURING	DOCKET NO. E-01773A-00-0826 DECISION NO. _________ ORDER

Open Meeting
July 24 and 25, 2001
Phoenix, Arizona

FINDINGS OF FACT

1. On October 11, 2000, Arizona Electric Power Cooperative, Inc. ("AEPCO" or "the Cooperative") filed an application for approval and confirmation of various transactions enabling the Cooperative's restructuring into three affiliated entities. The approvals and confirmations requested include:

A.) Approval of the transfer of AEPCO's transmission assets to Southwest Transmission Cooperative Inc. ("Southwest") and approval of the transfer of its cooperative service provider business to Sierra Southwest Cooperative Services, Inc. ("Sierra").

B.) Approval of AEPCO and Southwest to execute notes, mortgages and assumption and indemnity agreements associated with the restructuring.

C.) Approval of a partial requirements relationship between AEPCO and Mohave.

D.) Approval of the revised Class A member unbundled tariff and the forgiveness of the Purchased Power and Fuel Adjustment Clause.

E.) Confirmation that AEPCO has complied with the requirements of A.C.C. R14-2-1615 by this restructuring.

F.) Approval of waivers or, alternatively, approval of AEPCO's Code of Conduct.

G.) Confirmation that the financial commitment conditions of Decision No. 61932 pertaining to Sierra have been satisfied.

. . .

H.) Authorization of AEPCO, Southwest Transmission and Sierra to engage in any transactions and to execute any documents necessary to effectuate these authorization and complete the restructuring.

2. The initial application requested approval of revised rates that resulted in a rate decrease to AEPCO's members of 3.05 percent.

3. On April 11, 2001, AEPCO amended the application and eliminated the rate reduction proposed in the original application and proposed revised unbundled rates calculated to have no effect on AEPCO's revenues. AEPCO submitted rate base and other financial information as Exhibit C to the Amended Application demonstrating that the proposed rates would produce a rate of return of 7.35% on its total original cost/fair value rate base of $260,436,970 and 6.76% on its generation related rate base of $196,804,012.

Background

4. AEPCO is a non-profit Arizona rural electric generation and transmission cooperative primarily engaged in the generation, transmission, purchase, and sale of electricity at wholesale. AEPCO supplies all of the electric power requirements of its six Class A member-owned, not-for-profit distribution cooperatives ("Class A Members") under full requirement capacity and energy contracts. These members are Anza Electric Cooperative, Inc. (located entirely in California), Duncan Valley Electric Cooperative, Inc. (partially located in New Mexico), Graham County Electric Cooperative, Inc., Sulphur Springs Valley Electric Cooperative, Inc., Trico Electric Cooperative, Inc., and Mohave Electric Cooperative, Inc. ("Mohave"). These cooperatives serve a combined customer base of 114,720.

The Restructuring

5. AEPCO proposed to restructure into Southwest, Sierra and a restructured AEPCO.

A) Sierra, which already holds a CC&N as an Arizona Electric Service Provider, will market power, provide staffing and other resources to Southwest and AEPCO and will sell other electricity-related services.

B) AEPCO will be a generation cooperative that also acts as a power trader for short-term power.

C) Southwest will own and operate all of AEPCO's transmission.

6. AEPCO submitted a Study Committee Report on the Restructuring that outlined the

purposes for restructuring which include: to increase competitiveness of AEPCO and its members; create efficiencies; make available more flexible power purchases arrangements to AEPCO's members; and to diminish regulatory burdens.

7. The necessary agreements and contracts to implement the restructuring have taken over five years to prepare and coordinate, and has cost approximately $2.4 million for outside counsel and consulting fees, internal meetings, travel and other costs related to the restructuring.

8. AEPCO has agreed that the restructuring will not alter the existing jurisdiction of either this Commission or the Federal Energy Regulatory Commission ("FERC") over AEPCO and Southwest or over their generation and transmission rates.

9. AEPCO' s application requested that the Commission approve a tariff for AEPCO that will pass through Southwest's FERC approved OATT charges to its member cooperatives. AEPCO agreed that this Commission has jurisdiction over the tariff.

10. Southwest will finance the purchase of the transmission assets by assuming $96.2 million of existing AEPCO debt. Southwest will assume $66.1 million of RUS debt and guaranteed debt and will enter into assumption and indemnity agreements as to the balance of the assumed debt with other AEPCO lenders. These amounts are subject to adjustment at closing based on the final appraisal and AEPCO's financial statements at that time.

11. AEPCO's Class A members, along with AEPCO and Sierra, will all become members of Southwest. Southwest will be a non-taxable cooperative, subject to the annual member income qualifications under IRS Code Section 501c(12).

12. AEPCO will retain the generating assets and will continue to provide electric capacity and energy to its members, and others, using its generating units along with purchased power. Power trading, power billing and scheduling will be performed by AEPCO.

13. AEPCO will obtain transmission services from Southwest under Southwest's Open Access Transmission Tariff ("OATT") in order to continue to make bundled sales to its Class A all requirements members, SRP, Mesa, ED2 and MW&E and other third-party sales. When AEPCO makes a bundled sale, AEPCO will acquire transmission from Southwest or others, as needed. When AEPCO makes an unbundled sale to other parties, the customer will be responsible for obtaining

transmission whether from Southwest or other transmission providers.

14. AEPCO will remain a non-taxable cooperative, subject to the annual member income qualifications under IRS Code Section 501c(12). The income qualification is that at least 85 percent of its gross income will be "related income" from its members.

15. On August 27, 1999, the Commission issued Decision No. 61932, which granted Sierra a Certificate of Convenience and Necessity ("CC&N") to operate as an electric service provider and authorized Sierra to supply competitive retail electric services as a load-serving entity and as an aggregator in all areas of the State of Arizona which are opened to retail electric competition. The Decision also authorized Sierra to resell meter service and meter reading service.

16. This application also requests approval to transfer various non-generation and non-transmission AEPCO assets (primarily financial assets) from AEPCO to Sierra. Sierra will provide support services for AEPCO and Southwest. This support includes management of improvements and additions to facilities, employee development, contracting and subcontracting, warehousing, inventory control, fuel procurement, environmental permitting, engineering services, financial and accounting services, budgeting, forecasting planning and scheduling, media and public relations and legal services.

17. Sierra also intends to offer energy-related products such as distributed generation equipment, energy management, power quality solutions, facility operations and maintenance service, consolidated billing and other services.

18. Sierra will also engage in competitive retail electric sales activities and will function as a power marketer for wholesale power sales and load aggregation. However, pursuant to Commission rules, Sierra cannot offer competitive service in the Class A member distribution cooperatives' service area until the Commission has deemed those areas open to competition.

19. Sierra will be a taxable cooperative because, initially, the bulk of its income will come from its staffing services rather than the sale of electricity.

20. The application requested approval to transfer the transmission portion of AEPCO's CC&N to Southwest. After closing, Southwest will immediately generate revenues from AEPCO's Class A members and others. The employees who will operate Southwest's transmission system are currently the AEPCO employees who operate the same transmission system. For these reasons, Staff

believes that Southwest is a fit and proper entity to receive the transmission portion of AEPCO's assets and CC&N and recommends that the Commission approve the transfer.

Financing Issues

21. AEPCO's financial health has steadily improved since 1995. Except for the $6.7 million write-off of the PPFAC bank balance and $4.1 million shortfall charge-back expense related to sales to California, AEPCO's net margins (equivalent to net profit for an investor-owned utility) in 2000 would have been the highest in six years. Long-term debt has steadily declined, while membership capital (equivalent to "common equity" for investor-owned utilities) steadily increased and turned positive in 2000 for the first time in many years. Interest expense has also steadily declined over the six years. The balance of AEPCO's Cash and Cash Equivalents account, which represents cash and investments that are readily converted to cash, was $49.0 million at December 31, 2000.

22. The application also requested approval for AEPCO and Southwest to execute notes, mortgages and assumption and indemnity agreements associated with the restructuring. These will be necessary for the transfer of some of AEPCO's debt to Southwest.

23. Any debt assumed by or transferred to Southwest from AEPCO will be issued at identical interest rates and maturities as the debt presently carries. Because the amount of debt to be assumed or replaced by Southwest will not be known precisely until the close of the transaction, the Cooperatives have requested that approval for Southwest to execute notes, mortgages and assumption and indemnity agreements be for a total amount of up to $100.0 million. Also, AEPCO will need approval to issue replacement notes for the debt that it is retaining.

24. None of the debt for which approval is requested is "new" debt. The total will sum to AEPCO's debt immediately before closing. Staff believes that these debt transactions are necessary to effectuate the restructuring. Because Southwest's transmission rates and AEPCO's rates for generation are set to equal their revenue requirement and the debt service related to the assumed debt is part of that revenue requirement, Southwest and AEPCO should have the ability to make principal and interest payments on the assumed debt. If the restructuring is approved, Staff recommended approval for AEPCO and Southwest to execute notes, mortgages and assumption and indemnity agreements in an amount not to exceed AEPCO's debt immediately before closing.

25. AEPCO and Southwest will make cash capital contributions to Sierra in the amount of $4.0 million to enable its formation. Because substantially all of AEPCO's assets are subject to the Rural Utility Services ("RUS") and the National Rural Utilities Cooperative Finance Corporation mortgage, AEPCO is seeking a release of the Sierra business and assets from the mortgage.

26. The Restructuring Agreement executed by AEPCO, Southwest and Sierra provides that Sierra will be financed through capital contributions of $4.0 million from Southwest and AEPCO. Sierra has also applied for credit support in the amount of $500,000 from the National Rural Utilities Cooperative Finance Corporation ("CFC"). The funds from AEPCO, Southwest and the CFC will be used primarily to cover a thirty to forty-five day lag between the generation of revenue and the payment of payroll. These capital contributions and credit support fulfill Sierra's financial information compliance condition of Decision No. 61932.

27. AEPCO currently has a balance of approximately $200.0 million in RUS and RUS guaranteed debt. It also has other debt outstanding to other lenders including the CFC. To protect its interests in being repaid in a timely manner, the RUS imposed restrictions that AEPCO and Southwest must follow in the restructuring. One condition is the retention by AEPCO of the existing bundled sales contracts between AEPCO and the Class A all-requirements members.

28. The RUS also limited Sierra's control over the activities of AEPCO and Southwest because RUS will have no control over Sierra. The purpose of this restriction is to ensure that AEPCO and Southwest's their ability to make timely debt payments to RUS is not compromised by Sierra's activities.

29. Final RUS approval of the notes and replacement debt will occur after AEPCO and Southwest have received Commission approval of the restructuring of AEPCO.

FERC

30. On April 11, 2001, Sierra and Southwest filed an application with FERC relating to the restructuring of AEPCO. Sierra requested FERC authorization of a rate schedule for the wholesale sale of electric energy and capacity at market-based rates and for authorization for the Resource Integration Agreement which governs some of Sierra's wholesale power sales. Sierra also requested that FERC issue a declaratory order disclaiming jurisdiction over AEPCO and Southwest because

Sierra will not have operational control over either AEPCO or Southwest. Southwest requested that FERC make a finding that Southwest's Open Access Transmission Tariff is an acceptable reciprocity tariff and that its proposed Standards of Conduct satisfy the standards required by FERC Order No. 889. On May 30, 2001, without a hearing or suspension, FERC issued an order approving Sierra's and Southwest's applications.

Code of Conduct

31. AEPCO has requested approval of a Code of Conduct between itself and Sierra and between the Class A members and Sierra. These Codes of Conduct were submitted to comply with A.A.C. R14-2-1616. However, AEPCO contends that the Code of Conduct rules do not apply and, therefore, AEPCO requested waivers from these rules or, in the alternative, approval of the Codes of Conduct as proposed.

32. Although the three entities will have separate functions and each will have its own Board of Directors, the Boards will primarily be chosen from the same pool of individuals from which AEPCO's current directors originate.

33. In the restructured company, Sierra will perform several roles, which includes an overlap of roles in both the wholesale and retail markets. However, Sierra's role as a wholesale and retail marketer are not addressed in the proposed Codes of Conduct.

34. The market power study submitted to FERC by Southwest and Sierra reports that Sierra will provide personnel to fill non-core positions at AEPCO and Southwest. Staffing agreements will govern the functions of and payments for these employees. AEPCO and Southwest will provide management directives, policies, and supervision of Sierra's employees. The Sierra employees assigned to Southwest will be subject to the OASIS Standards of Conduct. Thus, structurally, Sierra employees will not have operational control over the activities of AEPCO or Southwest.

35. Sierra, as an electric service provider, will work in conjunction with the member distribution cooperatives, which are rate regulated utilities, through a Joint Marketing Agreement. For the other utilities in the state, a separation of the competitive provider and the utility is required. AEPCO contends that if it can not offer the competitive services through this arrangement, the services will likely not be provided at all in the rural regions of the state.

36. AEPCO has asserted that it and Southwest will comply with the FERC's rules, procedures and guidelines concerning the separation of the merchant and power marketing functions of an electric utility from its transmission functions and that appropriate standards of conduct will be followed to ensure adequate separation. AEPCO contends that the member owned corporate structure of the cooperatives minimizes Code of Conduct concerns because any margins in either market will accrue to the members.

37. AEPCO, Southwest and Sierra and the member distribution cooperatives are member owned and they serve a region of the state that would likely not be profitable enough for others to service is a factor in Staff's recommendation that the Commission approve the Code of Conduct at this initial stage.

38. Staff also recommended that the Commission reserve the right to impose additional restrictions if problems arise or if the demand for competitive services becomes larger than anticipated and would support other service providers in the rural regions of the state.

39. These issues according to Staff should be re-examined in AEPCO's and Southwest's next rate case.

Partial Requirement Contract

40. AEPCO has also requested the approval of a Partial Requirement Capacity and Energy Agreement with Mohave. As part of the restructuring, Mohave, AEPCO's largest Class A member, would convert from a full requirement member to a partial-requirement member.

41. Mohave would pay for electric service based upon a three-part charge, consisting of a fixed charge, charges based on an Operations and Maintenance rate and an energy rate charge. The fixed charge represents Mohave's share of AEPCO's debt payments and is instrumental in receiving RUS approval.

42. The restructuring will also provide the five remaining Class A, full requirement members the opportunity to seek to become partial requirements customers in the future pursuant to separate conversion agreements that would be subject to approval of the RUS.

43. AEPCO will supply Mohave power and energy based on its historic demand and investment. However, Mohave will be free to procure its additional needs from other sources.

44. Because Mohave will only participate in the wholesale market for its incremental needs, the recent volatility in electric prices should present a minimal risk. In return, the partial requirement arrangement provides Mohave the opportunity to pursue advantageous pricing arrangements as the wholesale market matures and becomes less volatile and chaotic. Therefore, the Partial Requirements Capacity and Energy Agreement should be approved.

Purchased Power and Fuel Adjustor Clause

45. The fundamental rationale for a fuel adjustment clause is that fuel prices can change radically based on the overall energy market. During much of the time that AEPCO's restructuring was being planned, fuel prices were dropping. During the more recent past, there has been a dramatic reversal of that trend. It is likely that for at least the near future, energy prices will be unstable.

46. Purchased power and fuel adjustor clauses for Arizona utilities may be created and set during a rate case wherein a base cost of fuel and purchased power is determined and included in base rates. The base period cost of fuel and purchased power adopted in AEPCO's last rate case and used in the subsequent fuel adjustor filings is $0.01714 per kWh. AEPCO's most recent filing of its fuel and purchased power cost adjustment indicated that its current cost of fuel and purchased power is $0.026034.

47. AEPCO's application requested the Commission's approval to: (1) forgive the under-collected balance in its PPFAC bank as of the effective date of the restructuring and (2) to eliminate its PPFAC on an on-going basis.

48. As of December 31, 2000 AEPCO's PPFAC bank balance was undercollected by approximately $6.7 million. Between January 1 and March 31, 2001, AEPCO has accumulated an additional undercollected balance of $2.3 million.

49. Staff has not audited the cumulative expenses included in AEPCO's reported undercollected PPFAC balance in several years. Staff cannot confirm the amount undercollected without a complete audit of the historical PPFAC filings, accounting and related invoices.

50. Staff has recommended that the Commission approve, nunc pro tunc, the write-off of the December 31, 2000 PPFAC, undercollected balance of $6.7 million.

51. Staff also recommended that the Commission order that a new docket be opened in

which to examine the PPFAC. Within the docket, Staff would perform an audit of the PPFAC filings to verify the balance and to verify AEPCO's compliance with previous Commission orders. Staff would make recommendations to the Commission as to the appropriate amount of the write-off and whether the adjustor should be continued or eliminated.

Rates

52. AEPCO also requested approval of rates for its Class A members. AEPCO's current rates to its Class A members were set by Decision No. 58405, dated September 3, 1993. The rates set were bundled rates of $15.25 per kW of billing demand plus $0.0228 per kWh. AEPCO's original restructuring application requested approval of a tariff that represented a rate reduction to its Class A members. AEPCO's amended application requested approval of a tariff that was designed to result in no change in the Class A members' total power bills.

53. AEPCO's amended application also requested that the rates for generation charged to its all requirements Class A members be set at $12.44 per kW of billing demand plus $0.01989 per kWh. Southwest's rates for transmission for Class A members and for all other parties are set forth in its Open Access Transmission Tariff ("OATT"), which has already received FERC approval. The OATT rates include a monthly demand charge determined by multiplying the proportion of the customer's load to Southwest's load by one-twelfth of Southwest's annual revenue requirement. The rate setting methodology is set forth in the transmission agreements between AEPCO and Southwest and Mohave and Southwest. According to the OATT, Southwest's revenue requirement for network integration transmission service is $13.4 million, "effective until amended by Southwest." This translates into initial transmission rates of $3.244 per kW per month.

54. Although the total of the generation and transmission demand rates of $12.44 and $3.244, respectively, equals $15.684 per kW and exceeds the bundled demand rate of $15.25 per kW, the new kWh charge of $0.01989 is less than the bundled kWh charge of $0.0228. When the unbundled rates are applied to the Class A members' bills for the twelve months ending December 31, 2000, the resulting pro forma power bills were $1.0 million less than the actual total power bills during 2000. On an individual basis, the pro forma power bills of the Class A members all were less than their actual bills. Thus, the impact on all of the Class A members, all factors held constant, should be that

their power bills will be slightly lower than they would have been under the old, bundled rates.

Future Rate Case

55. Although AEPCO expects some cost savings through Sierra's provision of centralized services, some costs may increase under the proposed restructured organization. The cost of the reorganization itself and the costs of educating, transporting and housing three Boards of Directors are costs that may increase.

56. Decision No. 58405 required AEPCO to conduct a fully allocated embedded cost of service study in conjunction with its next rate filing.

57. Staff has recommended that the Commission order AEPCO and Southwest to each file a rate case eighteen months after the closing of the restructuring for the following reasons: to insure that asset and liability allocations among the three entities have been performed in a fair and equitable manner; to insure that the ultimate customers of AEPCO benefit from any cost savings from the restructuring; to insure that AEPCO's and Southwest's rates are fair and reasonable; to determine if the allocations among the three entities were reasonable; and to determine if the restructured cooperatives were experiencing savings from the restructuring that exceed the costs.

58. A rate case that would be filed 18 months after the restructure has occurred would encompass one year of operations under the new structures and provide the cooperatives an appropriate amount of time to close the books and to prepare a rate case submission.

Notice

59. AEPCO's member cooperatives have received notice and agree to AEPCO's application.

60. AEPCO published notice of the Application in the Daily Star and in Kingman and Sierra Vista newspapers.

Recommendations

61. Staff recommended approval of the restructuring and the transactions to effectuate the restructuring. However, because of the many issues raised by this application and the volatility of the energy market, there are several conditions that should be attached to the Decision in this matter.

62. Staff recommended approval of the forgiveness of the December 31, 2000

undercollected PPFAC balance. However, Staff also recommended that the Commission authorize Staff to open a docket and request a procedural order be issued within 90 days from the decision in this docket. The purpose of the docket would be to examine AEPCO's PPFAC. Staff would perform an audit of AEPCO's PPFAC filings and balance to verify the balance and verify AEPCO's compliance with previous Commission orders. At that time Staff will also make a recommendation regarding the continuation or discontinuation of the PPFAC and a recommendation regarding the balance forgiven.

63. Staff recommended that the Commission order that both the new AEPCO and Southwest file rate cases eighteen months from the closing of the restructuring. In the rate applications, AEPCO and Southwest should include an analysis of the savings and benefits enjoyed from the formation of Sierra that would not have been experienced without the restructuring and include a cost of service study as ordered by Decision No. 58405.

64. Staff recommended that the Commission approve the Codes of Conduct attached as Exhibit D to the Application but reserve the right to impose additional restrictions on Sierra at the time of AEPCO and Southwest's next rate case if problems arise regarding Sierra's role as a wholesale purchaser and a cooperative service provider, or if the demand for competitive services becomes larger than anticipated and would support other service providers in the rural regions of the state.

65. Staff recommended that the Commission require Southwest to obtain any necessary franchises and file them in this docket when obtained.

66. Staff recommended that the Commission find that to the extent A.A.C. R14-2-1615 applies to a generation and transmission cooperative, this restructuring complies with that rule.

67. Staff recommended approval of the transfer of AEPCO's transmission assets to Southwest and certain assets to Sierra.

68. Staff recommended approval of the transfer of the transmission portion of AEPCO's CC&N to Southwest.

69. Staff recommended approval of the execution by AEPCO and Southwest of notes, mortgages and assumption and indemnity agreements associated with the restructuring, the total not exceeding AEPCO's outstanding debt immediately previous to the time of closing.

70. Staff further recommended approval of the partial requirements relationship between

AEPCO and Mohave, with the final executed agreement to be filed with the Commission upon completion of the restructuring. Such relationship should not differ materially from that described in the Application and its exhibits and schedules.

71. Staff recommended approval of the revised Class A member all requirement tariff attached as Exhibit B to the Amended Application.

72. In response to the Staff analysis, AEPCO agreed to most of the Staff recommendations but offered several points of clarification and suggested certain amendments to two of the Staff recommendations.

73. As to Staff's rate case filing recommendation in Finding of Fact No. 63, AEPCO noted the following:

(a) Although AEPCO and its members do expect efficiencies and other advantages from the restructuring as summarized at pages 5-6 of its Application, these benefits are primarily qualitative or unrelated to immediate direct cost savings and would be difficult to quantify in the savings benefit analysis suggested by Staff. Therefore, if the Commission orders a rate case filing, AEPCO requests that such an analysis not be required as part of it.

(b) AEPCO also suggested that if a rate case filing is required, submitting it two years instead of 18 months from the date of closing would allow a full fiscal calendar year to occur and would also allow the rate information to be premised on audited numbers.

(c) AEPCO suggested that the Commission not order, as recommended by Staff, a rate case submission in 2003. Citing the expense and considerable cooperative and regulatory resources involved in such a filing, AEPCO maintained that there was no demonstrated need for such a requirement and it was premature and unnecessary.

(d) Alternatively, AEPCO suggested that the rate and cost of service study filing requirement instead be an informational submission to the Director of the Utilities Division two years after closing. This would provide Staff with information without prematurely committing this Commission and the cooperatives to a possibly unnecessary rate case.

74. Having reviewed the Staff recommendations and AEPCO's response, the Commission finds that no rate case filing should be ordered at this time.

75. In a response to Staff's Code of Conduct recommendations in Finding of Fact No.

64 and its discussion of the subject in Findings of Fact Nos. 31-39, AEPCO noted that all electric service providers will operate in both retail and wholesale markets as will Sierra. As to Staff's stated concerns of Sierra working with member distribution cooperatives, AEPCO noted that the Code of Conduct contains various safeguards to assure that this does not confer a competitive advantage including the requirement that confidential customer information only be released after written customer authorization and be supplied to any other ESP on the same basis as it is provided to Sierra. Finally, AEPCO suggested that while the Commission retains jurisdiction to revisit issues associated with any approved Code of Conduct, that should not be done in the cooperatives rate cases, but rather in a proceeding noticed for that purpose for either AEPCO or the member distribution cooperatives.

76. Having reviewed the Staff recommendations and AEPCO's response, the Commission approves the Codes of Conduct attached as Exhibit D to the Application but reserves the right to address them further in proceedings noticed for that purpose involving AEPCO or the member distribution cooperatives.

CONCLUSIONS OF LAW

1. AEPCO is an Arizona public service corporation within the meaning of Article XV, Section 2, of the Arizona Constitution.

2. The Commission has jurisdiction over AEPCO and over the subject matter of the Application.

3. The Commission has reviewed the Application, Staff's Memorandum and the Staff Report and has determined that Southwest is a fit and proper entity to purchase AEPCO's assets and receive the transmission portion of AEPCO's CC&N. The Commission has also determined that the transfer of assets from AEPCO to Sierra is in the public interest and the proposed financing transactions are compatible with sound financial practices and are in the public interest. The Commission has also determined that the rates set forth in the tariff filed with the application are just and reasonable.

4. The Commission has determined that Staff's recommendations, set forth in Findings of Fact Nos. 61-71, as modified in Findings of Fact Nos. 74 and 76 are in the public interest and should be adopted.

ORDER

IT IS THEREFORE ORDERED that the Commission hereby approves AEPCO's application consistent with Staff's recommendations listed in Findings of Fact Nos. 61-71 as modified in Findings of Fact Nos. 74 and 76.

IT IS FURTHER ORDERED that AEPCO, Southwest and Sierra are authorized to engage in any transactions and to execute any documents necessary to effectuate these authorizations and complete the restructuring.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION

CHAIRMAN COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto, set my hand and caused the official seal of this Commission to be affixed at the Capitol, in the City of Phoenix, this ________ day of ______________, 2001.

BRIAN C. McNEIL
Executive Secretary

DISSENT: ______________________

DRS:LAJ:mai

SERVICE LIST FOR: ARIZONA ELECTRIC POWER COOPERATIVE, INC.
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